THE PERIODIC REVIEW, INNOVATION AND THE SUPPLY CHAIN

Richard Price, Chief Executive, Office of Rail Regulation
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Businesses in the railway's supply chain have a critical role to play in building a railway fit for the 21st century. Not just in terms of providing the material used in managing and renewing fixed infrastructure and rolling stock, but also technology, innovation and expertise. And you have a crucial part to play in delivering on the value for money agenda set out in the McNulty Rail Value for Money Study[1], which ORR co-sponsored.

Rail is a success story in Britain: it has seen sustained growth in demand, satisfaction and performance at or near to record levels; a good recent safety record; and the highest passenger numbers since the 1920s on a much smaller network. Yet costs remain far too high and need to be tackled. This sets the context for our Periodic Review – which started last year and concludes in June 2013. The Review will set the financial framework and the outputs to be delivered for Network Rail, and incentives across the industry, for the five years from 2014-15.

As part of its commitment to building a stronger economy for the future Government is continuing to invest significantly in railway infrastructure and commuter links. When existing commitments are combined with additional planned investments in electrification and Crossrail, around £5 billion of enhancement is already committed for the five years of our Control Period 5 starting in 2014.

We shortly expect to receive the specifications from the Governments in London and Edinburgh for what they want the railway to deliver in the five years from 2014-19 which could conceivably result in further investment; and the Welsh Government is also setting out its ambitions for rail. A planned £32bn investment in HS2 is further evidence that Government sees the case for investing in rail. These are serious amounts of public money. And at a time when fiscal consolidation means that public spending is under massive pressure across all budgets, the Governments' commitment to rail is rising, not falling.

A key question, highlighted by McNulty, is whether this level of public subsidy is sustainable and whether future governments will continue to invest in rail infrastructure. That is why value for money really matters. All sensible analysis shows that rail costs more than it should – indeed the industry's own plan for the 2014-19 control period[2] has already

[1] *Realising the potential of GB Rail: final report of the Rail Value for Money Study*, 19 May 2011
[2] *Initial Industry Plan England and Wales: proposals for CP5 and beyond* and *Initial Industry Plan Scotland: proposals for CP5 and beyond*, 29 September 2011

confirmed Roy McNulty's conclusion that the industry can reduce its costs by at least £2.5bn by 2019; and our analysis shows that it is possible to go some way beyond this.

Following this through is critical if the industry is to give funders confidence that it can deliver efficiently – particularly when there are competing calls on public money. And for the longer term, I want to see an industry which is less dependent on government capital and is in a position to raise its own investment, so that the industry itself is more in control of its own destiny, and can take more of its own decisions on how best to innovate, invest and grow.

Sorting out efficiency and whole-life costs – across the range of operations and maintenance through to new build – is at the core of the investment proposition whether it's government or the markets providing the capital. Value of money is the industry's license to grow. And the industry's suppliers have a huge role in bringing the know-how and innovation needed to achieve this step-change.

Since arriving at ORR just over a year ago I have been struck by how resilient rail has been in the economic downturn and how it is set to see increased numbers of passengers across all of the markets it serves as well as growth in freight. The industry plans published last September were built on long-term traffic forecasts, and suggested that growth across all sub-markets is likely to be significant. This is good news – but also presents some real challenges for the industry in Control Period 5 and beyond. For instance with regard to the London and South East market, traffic is predicted to grow by almost 50 per cent by 2025, with revenues expected to increase by more than 80 per cent in the same period. In long distance passenger market, demand is expected to increase by almost 60percent by 2025 and revenues by over 85 per cent over the same period. These significant forecast increases in passenger growth are matched by forecasts for rail freight, where freight tonne kms are expected to almost double by 2025.

To sustain this level of growth across the industry will require greater innovation - both in terms of new technology and ways of working. As McNulty also suggests, up to £190m of savings each year could potentially be derived from greater innovation in the industry. There are still a number of barriers to innovation which we are working with industry to resolve. The industry is still very risk averse where type approvals and changing of standards can sometimes be a drawn out process. Archaic work practices tend to stifle innovation with vested interests in maintaining the status quo. We are driving Network Rail towards producing better unit cost information. It has an ambitious project to deliver step-change improvements in asset information through its ORBIS project, which we support and are currently assessing.

We recognise that we have a role to play in encouraging innovation and we are actively involved with various industry groups to monitor and influence change. Another way we can directly incentivise change is by setting challenging efficiency targets for Control Period 5 where innovative approaches could be developed or applied to extend asset lives, improve productivity and reduce operating costs.

The best performing organisations are those that embrace innovation and adopt a continuous learning approach to derive a sustainable competitive advantage. Rail also faces strong competition from other forms of transportation which are not standing still either.

A 21st century rail industry must also contribute to the Government's commitment to the development of a sustainable green economy. The domestic transport sector accounts for around 20 percent of the UK's carbon emissions. Rail contributes to these emissions but is relatively environmentally friendly when compared to road and air. Nevertheless the ORR will support the industry in increasing its positive contribution to the environment, primarily through setting the appropriate incentives to encourage greater energy efficiency by the industry. This assessment of the bigger picture and building a 21st century railway is important context for understanding where we are now in preparing for the next Control Period and how this relates to meeting the McNulty challenge.

But I know that what most of you here today would like me to tell you is how this will all translate into the programme of work to be delivered from 2014 and when this work will be tendered.

The short answer is a positive one – the railway will continue to grow and maintenance and renewals work is not going to stop because it is the end of the Control Period. As I said earlier, we know that a large volume of enhancement work is already committed. The industry plans set out a range of proposed investment projects for Control Period 5 including a number of electrification schemes that the Government has already indicated it wants to proceed with (including Great Western and North West England) and making a start on the concept of the Northern Hub. We welcomed and support the industry's response to the McNulty study set out in the industry plans and our advice to the Secretary of State and Scottish Ministers[3] on the range within which we expect to determine Network Rail's revenue requirement for Control Period 5, was based on the industry plans.

On efficiency, the industry plans reflected the low end of the savings set out as achievable by McNulty (a reduction in industry cost of £2.5bn per year by 2018/9). This is encouraging, but our ambition is to build on this and see the industry deliver efficiencies towards the higher end of the range (a £3.5bn per year reduction in industry costs by 2018/9). But delivery of the higher end of the McNulty efficiencies will depend not only on ORR and on

[3] *Advice to the Secretary of State for Transport on Network Rail's costs and outputs in CP5 (England and Wales)* and *Advice to Scottish Ministers on Network Rail's costs and outputs in CP5*, 15 March 2012

Network Rail: the respective governments, train operators, ROSCOs and all of you working in the supply chain must all play a part.

I know that you also want to see greater continuity of procurement planning and a smooth transition from Control Period 4 to Control Period 5. So do we. Our recent supply chain management study suggests that Network Rail could get annual costs in this area down by £300-£400m through better procurement, workbank planning, project management and more collaborative working with all of you in the supply chain

There is plenty that can change here. We want to see tough competition in the supply chain, with suppliers creating opportunities to offer cost reductions to Network Rail. We are also very clear that Network Rail itself needs to change its approach to help you to engage in that way:

- We expect Network Rail to be a challenging customer – challenging suppliers to help it reduce whole life costs and raise quality. That requires it to be challenging and intelligent in its buying.
- That is why we want to see Network Rail giving more performance based specifications for equipment rather than engineering prescription which can restrict the supply base and drive up costs unnecessarily
- We want to see better planning – for example we are pressing Network Rail to improve its asset policies – and as it does so we would expect to see more stability and predictability in maintenance and renewals profiles; and less boom and bust;
- We already have measures – such as 'Early Start' – in place that should mean Network Rail is already able to plan and deliver work across control periods, avoiding the 'stop-start' that I understand happened at the start of Control Period 4.
- Operations accounts for around 18 per cent of Network Rail's costs, and we think a step change in efficiency could be achieved through the delivery of Network Rail's new operating strategy. No-one denies that the full plan will take time to implement. But we will be challenging Network Rail to maintain the pace so savings can be delivered sooner rather than later.
- We are driving Network Rail towards producing better unit cost data. Network Rail have an ambitious project to deliver step changes improvements in asset information through the ORR's project, which we support.
- An open competitive supply market needs better information from Network Rail on what's due to be procured and when. So I really welcome what Network Rail has done to get more of this information readily accessible on its website. It's not perfect, but it's a really positive step, and it's one way in which Network Rail is now some way ahead of most UK utilities.
- There are signs that Network Rail is moving a long way towards a better relationship with suppliers on its major enhancements projects. We have pushed them to learn

the lessons from past problems – such as the West Coast Main Line upgrade. I'm impressed with what Simon Kirby is achieving here.

- I also welcome what Network Rail is doing to expand alliancing into its suite of contracts with the supply chain, with many projects – such as those on the Hitchin grade separation, North Doncaster chord and Nottingham Hub – already up and running and others (like the Stafford area improvement) in the pipeline.
- This approach, whilst used in other sectors, is new to rail. We are keen to see how these alliances can foster greater collaboration and innovation, and improve transparency on workbanks for those suppliers involved in the alliance giving them increased scope to influence design and specification. This more 'open book' approach should lead to reductions in project costs and better value for money, with better sharing of risks.
- But I also know that Network Rail's bureaucracy in purchasing is getting better but has been legendary, with people monitoring other people who are monitoring people monitoring contracts month in month out - even where those contracts are fixed price. It is often over the top- and contrary to popular belief it is absolutely not something we require as a regulator.

Ironically of course one of the things we can do to tackle that is to push the company towards greater efficiency so that they can't afford wasteful and counter-productive bureaucracy – so as we tighten the screw on value for money, in some ways your engagement with Network Rail should improve.

We are already looking at what can be done to improve Network Rail's planning and delivery across control periods. But we know from talking to you that you don't always see this working in practice. I want to make sure ORR understands that better. We need to understand what is not working and make sure that Network Rail takes the necessary action.

That does not mean we can or should intervene in individual procurements; we are not here to tell Network Rail or any of you how to run your businesses. But there are things we can do to up the pace of change, and to drive the right behaviours from Network Rail as a monopoly business. We want to understand what you see in other sectors that you don't see in rail. We know that elsewhere there are innovative approaches to risk-sharing in contracts, and on complex projects, for example, and we want to understand what the scope is to doing more of this in rail.

As Network Rail gets better at planning ahead, and its operating strategy and asset policies come into play, are you able to sit down with them and say what greater predictability on volumes and flex in specifications means you can offer in better contract terms – and are they listening? How much of the improvement in Network Rail I have been talking about are you actually seeing in practice? Or is it all news to you? I want to understand how it looks from your perspective.

As well as creating pressures for more competition AND more collaboration to improve efficiency, I also want us to get a better grip of what we in ORR can do to avoid getting in the way. On industry standards for example - is there over-specification, and how much of that is down to the industry and how much down to us as the regulator?

In the next few weeks we will be in discussion with supply industry to establish how best to get feedback from individual suppliers. That intelligence will help us to shape both the Periodic Review and the way we regulate more generally so we can encourage Network Rail and the industry more generally to work with the supply chain to get better value. I want people in the supply chain to be able to tell us confidentially, in their experience where and how procurement should be done better.

The outcomes that customers, funders and the public want from the rail industry are delivered by the industry as a whole, working together. These are not the sole product of any one company or part of the value chain.

There are of course big opportunities for innovation from the supply chain in other areas I have not talked about this morning – including franchise retendering and open access competition; from devolution in Network Rail, and alliancing between Network Rail and the train companies.

Although Network Rail is already implementing the approaches I have talked about in some areas, we will challenge them to ensure they have made best use of them wherever they can drive better value for money.

Summing up

As I have said, by the end of next month we will receive the high level specifications from the Governments in Edinburgh and London. Immediately following this at the start of August we will consult on the regulatory targets and key performance indicators we could put in place to monitor the delivery of these high level outputs and potentially other outcomes that customers and society value.

Looking further ahead, we will be consulting on Network Rail's strategic business plan in February (although we expect Network Rail to be engaging with suppliers during its development) and on our Draft Determination next June.

It is absolutely vital that you engage in this process to help us to achieve the best possible outcomes.

This is not a story of gloom and doom. Almost never has so much been spent on upgrading and enhancing Britain's railways. And that is remarkable against a background of hard economic times. We have to be sure that the public and rail customers get value for that. I see positive change in the industry – I also see much further to go.

We want to see Network Rail working more collaboratively with you. We want to see an end to peaks and troughs in planned work. We want to see more innovation.

We need your help to make it happen.

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